

Main epochs of economic thought

- **Pre-classical economics** (8th century BC – 1776)
 - early pre-classical economics (8th c. BC – ca. 1500)
Ancient Greeks, Scholasticism
 - late pre-classical economics (ca. 1500 – 1776)
Mercantilism (16th – 18th c.)
Physiocracy (ca. 1750- ca. 1789)
- **Classical economics** (1776 – ca. 1870)
Adam Smith, David Ricardo, John Stuart Mill
- **Neoclassical economics** (ca. 1870 – ca. 1930)
Alfred Marshall, Leon Walras
- **Modern economics** (ca. 1930s until today)

Late pre-classical economics (ca. 1500 – 1776)

- Mercantilism (16th – 18th centuries)
- Physiocracy (ca. 1750 – ca. 1789)

General characteristics of the period

- increase in economic activity
- markets become more important
- still pre-industrial economies, agriculture is the most important sector of the economies
- economic thought is developing from simple applications toward more complicated views of the economy

Main mercantilist ideas

- very diverse views on economic problems
- no systematic accounts of the entire economy
- the main economic problem: best economic policies for promoting the power and wealth of the nation, policies for increasing the power and prosperity of the nation
- assumed that the total wealth of the world is fixed and constant (zero-sum game assumption)
 - What do you think about that?
 - Average real global per-capita Gross Domestic Product increased by 38% from 1600 to 1800. Over the 200 years, as free-market ideas and practice took root, global GDP per capita increased by at least 1200%
 - GDP is the monetary measure of the market value of all final goods and services produced in a period (quarterly or yearly)
- the goal of the economic activity is production
 - And about that?

Mercantilism (16th – 18th centuries)

- ideas produced in all European countries
- mercantilist writers were mostly merchant businessmen, bankers, practitioners of the economy etc.
- often focused on economic questions related to the writers' particular private interests
- huge growth in the quantity and quality of economic literature

Mercantilist ideas, cont.

- mercantilists advocated encouraging production, increasing exports and holding down domestic consumption
- they insisted on low wages of laborers to give the economy competitive advantage in international trade; wages should be set on the subsistence level (minimum income covering biological needs only); higher wages would lead to a decrease in labor supply and fall in the national output
 - What do you think about that?
- so in result, they advocated the poverty of the masses
- they insisted on the notion of the positive balance of trade
- balance of trade is the difference between the monetary value of exports and imports. A **positive balance of trade** is known as a **trade surplus** and consists of exporting more than one imports: $E > I$.
- Negative balance (**trade deficit**) of trade: $I > E$

Positive balance of trade

- mercantilists argued that in order to increase its wealth a nation should in the first place achieve a positive balance of foreign trade
 - Is balance of trade a good indicator of wealth?
 - Is positive balance of trade a good policy? Do we need imports?
 - What are the dangers of trade deficit?
- therefore, according to mercantilists a country should increase exports and discourage imports by means of tariffs, quotas, subsidies, and taxes
- secondly, the government should stimulate national production by intervening in the economy, especially to help economic sectors producing export goods.
 - What about this policy?

Mercantilism today, 1

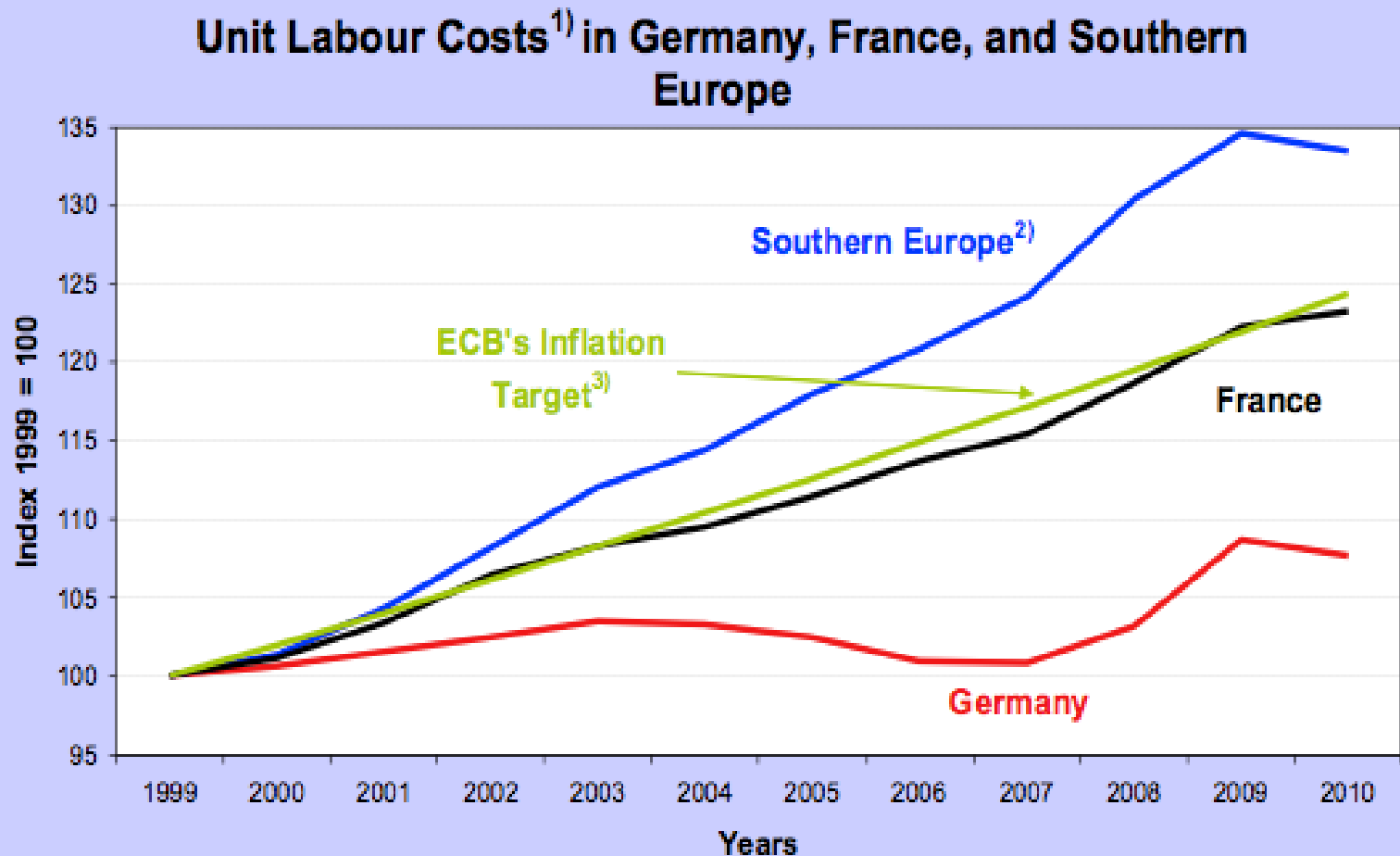
Surplus in Billion US-Dollar

Rank ↕	Country ↕	Surplus (2011) ↕
1.	 Saudi Arabia	252.756
2.	 Germany	219.938
3.	 Russia	198.760
4.	 China	155.142
5.	 UAE	80.000
6.	 Kuwait	72.800
7.	 Qatar	72.000
8.	 Norway	67.982
9.	 Nigeria	64.000
10.	 Netherlands	63.145

Deficit in Billion US-Dollar

Rank ↕	Country ↕	Deficit (2011) ↕
1.	 USA	-784.775
2.	 UK	-162.973
3.	 India	-154.401
4.	 France	-117.676
5.	 Turkey	-105.862
6.	 Spain	-64.691
7.	 Hong Kong	-55.630
8.	 Italy	-33.872
9.	 Japan	-31.593
10.	 Egypt	-28.375

Mercantilism today, 2



¹⁾ Index of ULC of total economy 1999 = 100. ²⁾ Greece, Portugal, Spain, and Italy. ³⁾ Yearly increase of 2%.
Source: AMECO database (updated May 2011), own calculations.

Mercantilism today, 3: Donald Trump

- Foreigners are “killing us on trade” because Americans spend much more on imports than the rest of the world spends on American exports. China’s unbalanced trade with the United States, he said Tuesday night, is “the greatest theft in the history of the world.”
- “Our trade deficit with China is like having a business that continues to lose money every single year,” Mr. Trump told The Daily News in August. “Who would do business like that?”
- In January, Mr. Trump proposed a 45% tariff on Chinese imports during a meeting with the New York Times editorial board. “I would tax China on products coming in,” he said. “I would do a tariff, yes.”

Why mercantilists argued for the positive balance of trade?

- Early mercantilists (bullionists) defined nation's wealth in terms of its holdings of precious metals like gold or silver (bullion).
 - Is this a good concept of wealth?
- These were the times when money was mainly gold or silver coins
- A positive balance of foreign trade ($E > I$), would lead to a flow of gold/silver into the economy
- Therefore, it would increase nation's wealth understood as the amount of bullion.

Why later mercantilists argued for the positive balance of trade?

- According to later mercantilists, wealth should be measured in real (non-monetary) terms (the level of production or real output).
- But, monetary factors (money supply = amount of circulating coins) are the chief determinants of the economic activity
- More money = more credit and more investment in the economy
- Therefore, they thought that increases in the quantity of money generate increases in the level of production or real output.
- Hence, a positive balance of trade (that is a flow of gold money into the economy) would increase overall production or real output, and therefore contribute to the increasing wealth of nation.
 - What do you think about this argument?

Theoretical achievements of mercantilists

- explicit recognition of the possibility of objective, scientific analysis of the economy
- understood that government intervention is limited by the economic laws
- implicitly used some economic “laws”, like the law of supply and the law of demand
- used the concept of an economic man and the profit motive
- recognized some errors of their predecessors
- ... but none of mercantilist writers were able to produce an integrated view of the operation of market economy (the process of price formation and resource allocation).

David Hume, *Political Discourses*, 1752

- Assumes that we live under the gold standard
 - International payments are in the form of gold
- Price specie-flow mechanism – positive balance of trade ($E > I$) leads to an increase in the specie within (English) economy, which in turn leads to ...
- a rise in the level of prices in this economy (with a positive balance of trade), and...
- in effect, exports in England will decrease and imports will increase because England prices will become relatively higher than those of other economies.

Hume's price specie-flow mechanism

- The opposite tendencies will prevail in an economy with an initial negative balance of trade.
- This process will ultimately lead to self-correction ($E=I$) of the trade balance in all countries in the long-run.
- Therefore, mercantilist policy of maintaining a positive balance of trade is self-defeating, it is impossible to have a positive (or negative) balance of trade in the long-run.

Physiocracy

- Short-lived movement, active from ca. 1750 to ca. 1780
- Considerable influence on subsequent economic thought
- First school of economic thought in the history of economic for three reasons:
 1. Physiocracy developed exclusively in France
 2. Short-lived movement, 1750-1780
 3. Intellectual leader of the group: Francois Quesnay (1694-1774)

Francois Quesnay (1694-1774)



Francois Quesnay (1694-1774)

- Quesnay was a medical doctor in French king's court
- Made analogies between economics and medicine, e.g. circulation of money/circulation of blood
- Physiocracy = the rule of the nature, the authority of nature

Philosophical ideas of Physiocracy

- Natural order vs. positive order
- Natural order is being made up of beneficial and self-evident rules, created by God, that govern the operation of society and the economy.

Examples:

- right to acquire property through labor
- the right to pursue one's own interest
- the right to survival
- duty to respect other persons and property of others
- the right to voluntary exchange, etc.

Natural vs. positive order

- Positive order is human legislation.
- Positive order should be consistent with natural order, if economy is to be prosperous.
 - What do you think about this argument?

Economic situation of 18th century France

- Economic underdevelopment – old technology in agriculture
- Severe economic and financial problems (shortages of food, hunger, large military expenditures)
- Immense popularity of state interventionism (price-fixing, large number of taxes, direct coercion of producers)

Theoretical achievements of Physiocracy

- Assumptions of physiocratic model:
 - The sole origin of wealth is in agriculture
 - Idea of natural or net product
 - Net product is the surplus in agriculture production over the costs of production
 - Net product is created only in agriculture (it results from the productivity of nature, land)
 - Other sectors of the economy (trade, manufacturing etc.) are sterile, they do not produce net product

Quesnay's *Tableau economique*, 1758

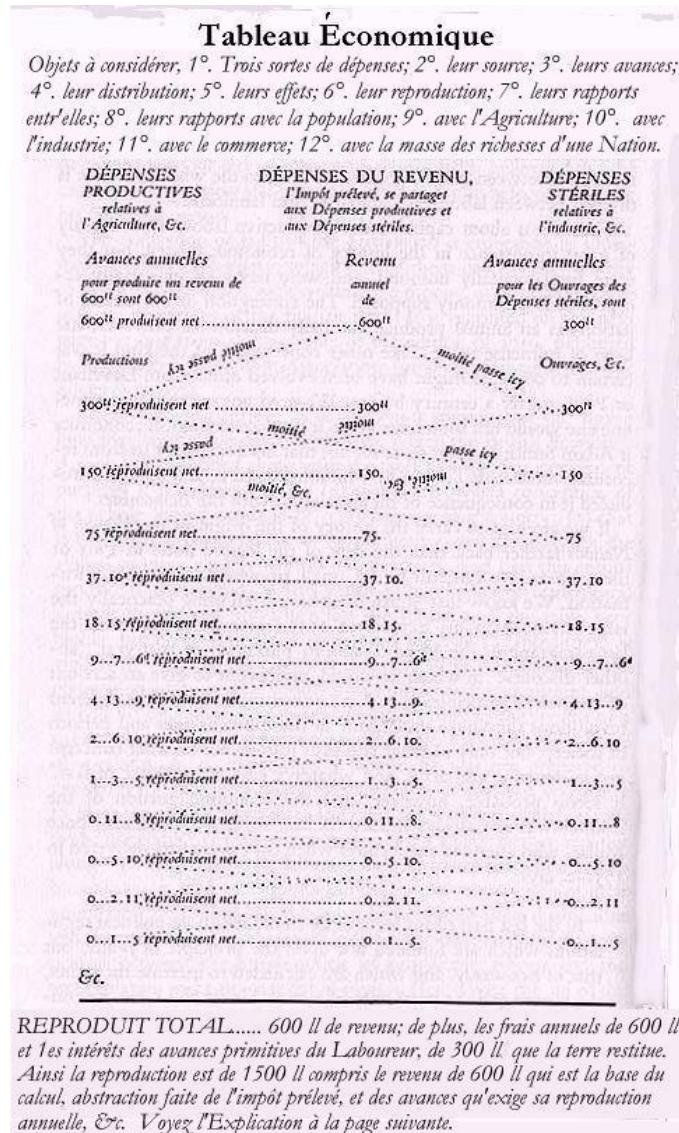
- Assumptions:

5 million – value of the agricultural production

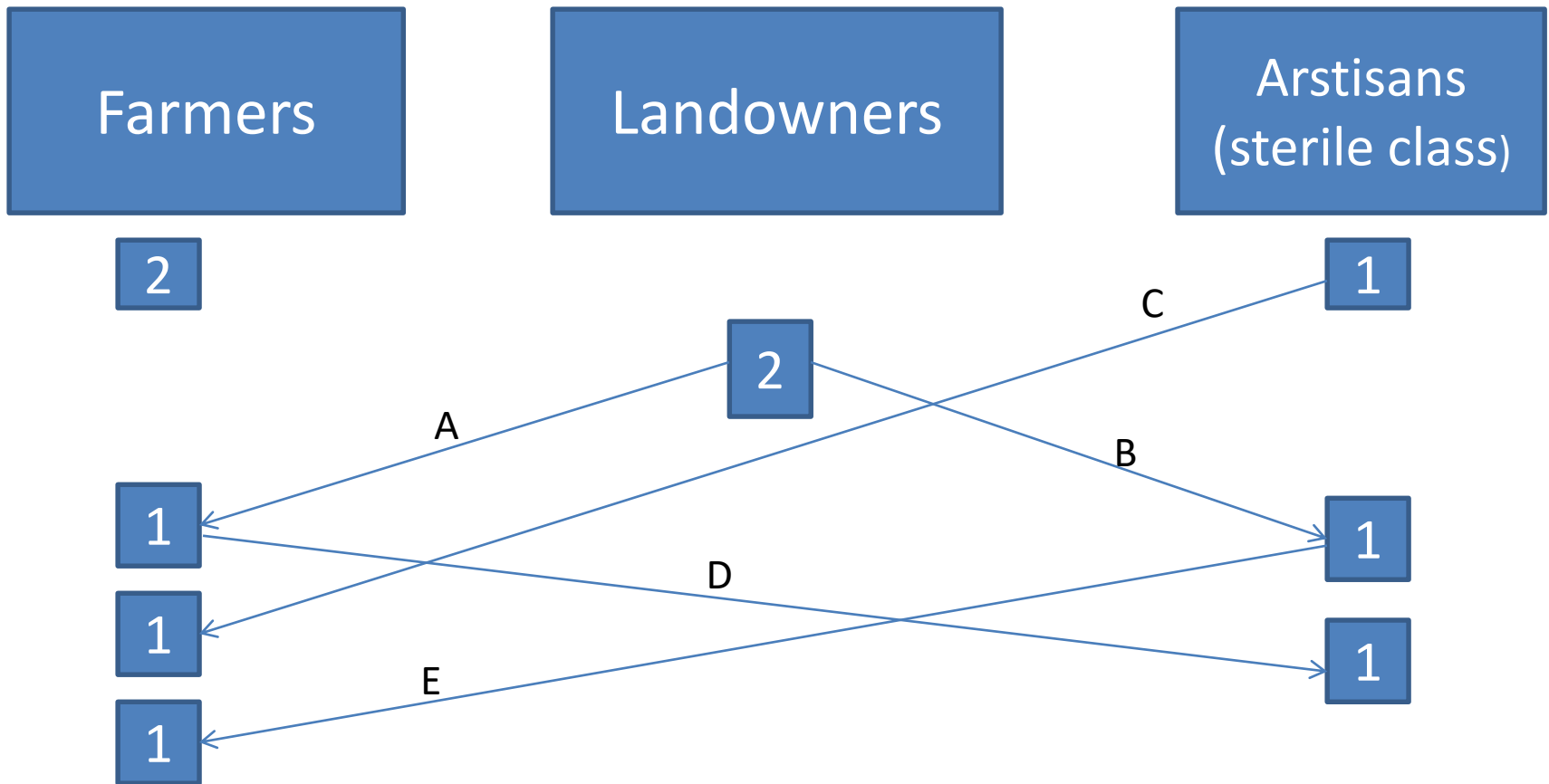
3 million – costs of production in agriculture (1 – depreciation of fixed capital, 2 – wages)

2 million – net product

Quesnay's *Tableau économique*, 1758



Quesnay's (simplified) model from *Tableau economique*, 1758



Insights from *Tableau economique*

- Flow of incomes between social classes (sectors)
- Creation and circulation of the net product
- Interrelatedness, independence of all sectors of the economy

Physiocratic economic policy

- Competition leads to the best (lowest) price
- The burden of taxes is shifted to the land
- So, there should be only a single tax – levied on land (about one third of the net product)
- Economy is largely self-regulating
- Laissez-faire policy
 - "laissez-faire" in French means "let [them] do," implies "let it be," "let them do as they will," or "leave it alone.,,"
 - Laissez-faire system demands that the role of state in the economy should be minimal, because economies are largely self-regulating
- Abolish all mercantilist regulations